IN THE

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1978

Nos. 78-606 and 78-607

The Pacific Telephone and Telegraph Company,
Petitioner,

v.

The Public Utilities Commission of the State of California, Et Al.,
Respondents.

General Telephone Company of California,
Petitioner,

v.

The Public Utilities Commission of the State of California, Et Al.,
Respondents.

BRIEF OF RESPONDENT TOWARD UTILITY RATE NORMALIZATION (TURN) IN OPPOSITION TO PETITIONS FOR WRIT OF CERTIORARI

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INTEREST OF TURN

TURN is a non-profit corporation organized under the laws of the State of California. It functions to represent the interests of residential consumers generally, as well as specific consumer organizations and constituencies. TURN participated in the proceedings leading up to the California Commission Decision and the proceedings of the California Supreme Court affirming the Commission Decision.

QUESTIONS PRESENTED

(1) Whether petitioners are properly before this Court where they (1) seek an advisory opinion on (2) State ratemaking issues which are supported on independent State grounds.

(2) Whether the federal tax statutes and/or IRS regulations that create permanent tax savings unlawfully dictate to a state regulatory commission the precise regulatory treatment that must be accorded the tax savings, in light of the Tenth Amendment to the United States Constitution.

STATEMENT

This appeal raises the question of how the tax benefits associated with accelerated depreciation and

the investment tax credit (ITC) should be treated for the purposes of intra-state utility ratemaking. In the state of California it has been ascertained that such tax benefits result in permanent tax savings as a matter of empirical evidence and as a matter of State law.[1]

For the period covered by the present proceeding (1970-1977) Pacific Telephone & Telegraph Company (Pacific) had accumulated tax savings of $925,000,000[2] and General Telephone Company (General) had accumulated tax savings of $265,000,000. The Commission Decision here on review ordered Pacific to refund to its customers $161 million of the tax savings and General to refund $55 million.[3] Those tax savings not refunded to customers were retained by the utilities as a ratepayer contribution to capital, contrary to normal regulatory principles.[4] The Commission also ordered ongoing rate reductions of $55 million for Pacific and $11 million for General to

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[1]See pages 7-14.

[2]This figure is taken from Pacific's Petition to the California Supreme Court, Appendix, pp. 71 & 73.

[3]These figures are for the years 1970-1977. Pre-1970 utility property and consequent tax savings are deleted because the federal tax statutes do not address these prior years.

[4]It is universal regulatory law and a basic tenet

reflect ongoing tax savings of the utilities. These sums also represent a small fraction of the actual tax savings of the utilities and represent a further ratepayer contribution to capital for any corporate purpose the companies choose.

These tax savings result from the use of normalization accounting for ratemaking purposes by both Pacific and General. Normalization accounting involves calculating federal taxes actually paid to IRS using accelerated depreciation while using straight line depreciation in calculating taxes for intrastate ratemaking purposes. Accelerated depreciation results in higher deductions and thus lower actual taxes paid to IRS. At the same time, straight line depreciation results in lower deductions and thus artificially inflated tax expense for ratemaking purposes. The end result of this accounting scenario is the charging of higher phantom tax expense to ratepayers based on straight line depreciation while the actual payment of lower taxes to IRS is calculated using accelerated depreciation. The difference

of capitalism that investors fund capital expansion, not ratepayers, who are captive customers of monopoly enterprises. See San Francisco v. PUC (1971) 6 C 3d, 119, 128, 98 CR 286; also Decision No. 87838, pp. 43A - 44A (The page numbers refer to the Joint Appendix filed by General and Pacific).

between the two tax figures (phantom tax) is the actual tax savings which is accounted for in a deferred tax reserve.[5] The phantom taxes reflected in the deferred tax reserve have already been collected from utility ratepayers by the utility. The disposition of these phantom taxes forms the backdrop to the present proceeding.[6]

Pacific and General seek by their petitions to have the entirety of the phantom taxes collected by the utilities from ratepayers, but never paid to IRS, retained solely for their own unrestrained use.

The Commission recognized that the tax benefits associated with accelerated depreciation and ITC resulted in permenent tax savings,[7] and that flow through accounting was the best method of handling these tax benefit savings.[8] However, it adopted a normalization accounting procedure which returned only a small percentage of the

[5] IRC section 167(1)(3)(G)

[6] The reason phantom taxes are created is that the utility collects taxes from its ratepayers that are never paid to IRS. The deferred tax reserve constitutes this phantom tax.

[7] Findings 16 and 19, p. 48A.

[8] Finding 2, p. 45A.

phantom taxes to the utility customers. The basic error of the Decision is the Commission's failure to return all of the phantom taxes to the ratepayer, not in returning only a small portion.[9] This view differs from the companies' assertions that any return of tax savings is in error.

Both General and Pacific misstate the relevant legal issues before the Court. What is involved is the use of regulatory principles in regard to an intrastate ratemaking matter. What is not involved is whether or not the particular regulatory treatment of taxes adopted by the California Commission is in accord with federal tax legislation and/or federal tax regulations.[10] The reason for this is that the federal laws involved here do not compel a state commission to use any particular method of treating federal income tax expense. What the Commission has done in the present case, and what

[9] TURN has until December 26, 1978 in which to file a Petition with this Court since we sought rehearing of the California Supreme Court decision.

[10] Although the Commission has stated a desire to preserve eligiblity, and has, in fact, calculated rates in accord with the requirements of eligibility, the Commission did not premise the Decision on eligibility being maintained. The Commission perhaps anticipated that eligibility to a great extent was in the hands of General and Pacific. See Decision No. 88215, Pacific Tel (1977) -Cal PUC-, which indicates the Commission's willingness to adopt flow through accounting if the Decision does result in ineligibility.

the California Supreme Court has affirmed, is to apply State regulatory ratemaking principles in regard to the tax expense issue. In this regard it is important to emphasize that in rendering its decision the Commission had before it three prior California Supreme Court decisions that enunciated the principles which were to govern the present proceeding. None of the Supreme Court decisions were appealed to this Court, even though these three decisions overturned Commission orders which adopted Pacific and General's version of normalization accounting. Furthermore, the Commission had before it three of its own prior decisions (aside from those overturned by the California Supreme Court) which enunciated ratemaking rules applicable to General and Pacific. These three Commission decisions similarly were not overturned by any higher judicial authority.

PRIOR COMMISSION DECISIONS

As early as 1960, the California Public Utilities Commission first had occasion to investigate the regulatory rate fixing treatment to be accorded accelerated depreciation in relation to section 167 of the federal tax code. In a case entitled Rate Fixing Treatment for Accelerated Amortization and Depreciation

of All Utilities (1960) 57 Cal PUC 598, the California Commission relied on two United States Supreme Court cases, Galveston Electric Co. v. City of Galveston, 258 U.S. 388, and Georgia Railway v. Railroad Commission, 262 U.S. 635, in concluding that

> "the ratepayers of a public utility could (not) be required, in any event, to bear the burden of ... more income taxes (than) were actually paid by the utility." 57 Cal PUC at 600-601 (emphasis added).

The Commission similarly concluded that the use of accelerated depreciation by a regulated utility results in permanent tax savings, stating:

> "The record in this proceeding is clear that public utilities, for the foreseeable future, will continue to construct new plant to an extent which will be sufficient to more than overcome retirements to such plant.[11] In such circumstances, the theory of normalization, based upon the concept of a deferred tax liability, would not have an opportunity to operate . . .
> "Based upon the record in this case, we find that, as applied to Section 167, there is created no income tax deferral and no deferred tax liability. The operation of said section provides a vehicle and a procedure whereby the taxpayer may reduce his taxes just as though the tax rate had been reduced. So far as tax liability may be concerned, the end result would be the same in each case. Should this Commission adopt the so-called normalization theory, we would be required to close our eyes to the obvious facts of the future which can reasonably be expected to result from California's tremendous economic growth. There is no duty incumbent upon this Commission to adopt a theory which is at war with the facts of experience and the reasonable expectations for the future." 57 Cal PUC 599, 600 (emphasis added).

[11] This finding was repeated in Pacific Telephone & Telegraph (1968) 69 Cal PUC 53, 61-63 and was affirmed as a matter of law in City & County of San Francisco v. PUC (1971) 6 C 3d, 119, 123, 98 CR 292; City of Los Angeles v. PUC (1975) 15 C 3d, 680, 686, 125 CR 779. See also Alabama-Tennessee Natural Gas Co. v. FPC (1966) 359 F 2d 318, 328, 366, cert den. 355 U.S. 847; Midwestern Gas Transmission v. FPC (1968) 388 F 2d 444, 447.

It is uncontested in the present proceeding that both General and Pacific "will continue to construct new plants to an extent which will be sufficient to more than overcome retirements to such plants." After the above decision, all major utilities in California with the glaring exception of General and Pacific elected to reduce taxes by taking accelerated depreciation and flow through the tax savings to their customers. In subsequent years, the Commission dealt with the refusal of General and Pacific to take advantage of accelerated depreciation, reasoning that

> "The establishment of public utility charges involves the assessment of all reasonable costs for a public service, including taxes . . . Generally, when management judgments produce results which are unfair to the ratepayer, regulation steps in. Pacific's management, reflecting the general Bell System policy, has seen fit to choose that method of computing income taxes which results in maximum tax costs and, hence, maximum charges to its ratepayers . . . A utility is a

collector of taxes from its patrons and even its costs of collection are borne by them; its 'payment' of taxes, in the final analysis, costs it nothing. Management's discretion has exceeded a reasonable and prudent course respecting income taxes, to the detriment of the public interest. For the rate-making purposes of this proceeding, therefore, we shall compute Pacific's income tax expense for the test year 1967 as though Pacific had taken the favorable option for which the law provides. Protection of the public interest demands such procedure." Pacific Tel. & Tel. (1968) 69 Cal PUC 53, 62-63.

Similarly, the Commission made ratemaking adjustments in regard to General in the following terms:

"General has not acted in a reasonable and prudent manner, all to the detriment of the public. It is reasonable to compute General's income tax expense for the test year on the basis of the use of accelerated depreciation beginning with plant addition in such year." General Tel. 69 Cal PUC 690 (1969).

General did not seek judicial review of the decision. As a result of these two decisions, General and Pacific, for ratemaking purposes, had their taxes computed on the basis of imputed accelerated depreciation and flow through.

The reason for the formal finding of imprudence was that Pacific and General, alone among major California utilities, persisted in using straight line depreciation when accelerated depreciation was available to them. Had the two imprudent utilities opted for accelerated depreciation, they would have saved themselves

and their customers millions of dollars in tax expense.[12] At any rate, the California Commission finally imposed regulatory restraints on General and Pacific by imputing accelerated depreciation in calculating taxes for ratemaking purposes. To this very day the Commission recognizes that "Pacific and General were imprudent in failing to select accelerated depreciation when that option was available under the federal tax laws." Decision No. 87838, finding 1, (45A).

Thus, California regulatory law had crystallized in regard to the regulatory treatment to be accorded federal tax benefits. The California Commission recognized that the use of accelerated depreciation resulted in permenent tax savings (and not a deferral) and that a utility had the affirmative obligation to use those tax accounting methods that resulted in the lowest tax expense. In recognition of these regulatory principles, the Commission passed along to utility customers the tax savings resulting from the use of accelerated depreciation. In those situations

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[12]The Commission found that between 1954-1967 Pacific could have reduced taxes $225,000,000 and thus reduced rates charged to their customers by $450,000,000. Taxes are collected from ratepayers on a 2 for 1 basis. $2 of ratepayer funds are required for $1 in taxes. Pacific Tel. & Tel. (1968), supra, at 61-63.

wherein the utility obstinately refused to opt for the benefits of accelerated depreciation, the Commission imputed the use of accelerated depreciation in calculating ratemaking expenses. This was the well established State of California regulatory law at the end of 1969.

TAX REFORM ACT

In 1969 Congress passed the Tax Reform Act to be effective starting in 1970. This act provided that utilities who had previously used straight line depreciation in computing taxes, including General and Pacific, could switch to accelerated depreciation only if they used straight line depreciation in computing tax expense for ratemaking purposes.[13] This practice, known as normalization, resulted in the utilities charging their customers higher taxes than were paid to IRS and retaining these funds for unrestricted use.[14] General and Pacific reversed their longstanding

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[13]IRC 167(l)(2)(B)

[14]Although there may be legitimate reasons for using tax laws to encourage private business investment in plant and equipment, public utilities are required as a matter of law to expand plant and equipment in order to provide adequate service. A utility is provided funds from ratepayers for this purpose and is allowed a return on their investment. If anything, unregulated capital expansion will result in unneeded plant and equipment which will be disallowed in rate base. See City of Pittsburgh v. Penn. PUC (1957) 17 PUR 3d 249.

refusal to take advantage of the tax benefits, and elected to opt for accelerated depreciation starting in 1970. The obvious reason for this change of position was the recognition by General and Pacific that they might now be able to keep all the tax savings to themselves while charging their customers a higher non-existent tax. All other California utilities are eligible to use accelerated depreciation for tax purposes with flow through of the tax savings to the utility customer. It is only because of the imprudence of Pacific and General in first refusing to elect accelerated depreciation and their continued obstinacy in refusing to change after being cited for their imprudent conduct, that they cannot now use accelerated depreciation with flow through.

CALIFORNIA SUPREME COURT DECISIONS

After the passage of the Tax Reform Act (TRA), the Commission in a series of decisions[15] sought to annul its prior practice of flowing through to utility customers the benefits of accelerated depreciation

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[15]Pacific Tel. & Tel. (1970) 71 Cal PUC 590; General Tel. (1970) 71 Cal PUC 657; General Tel. (1971) 72 Cal PUC 652/92 PUR 3d 224; Pacific Tel. & Tel. (1974) 77 Cal PUC 117; General Tel. (1974) 77 Cal PUC 558; General Tel. (1974) 77 Cal PUC 590.

and the investment tax credit (ITC).[16] The rationale given by the Commission for its abandonment of well established regulatory principles was that the federal tax statutes mandat d that the Commission retain the entirety of the tax savings associated with accelerated depreciation and the investment tax credit.

In a series of three unanimous decisions, the California Supreme Court reversed the above decisions of the Commission, holding that the Commission failed to consider lawful alternatives in dealing with the tax expense issue. City & County of San Francisco v. PUC (1971) 6 C 3d 119, 130, 98 CR 292; City of Los Angeles v. PUC (1972) 7 C 3d 331, 102 CR 313; City of Los Angeles v. PUC (1975) 15 C 3d 680, 125 CR 779.

In its 1971 decision the California Supreme Court noted that where a utility uses accelerated depreciation for actual tax-paying purposes, but adopts straight line depreciation for ratemaking purposes (normalization), it "deliberately overstates the actual tax expense." (6 C 3d at page 130.) The Court noted that the Commission could disallow accounting practices such as normalization, which result in unreasonably inflated tax expense. The

[16]The ITC first became available in 1971.

decision found that accelerated depreciation resulted in permanent tax savings and not a tax deferral, that requiring ratepayers to pay in rates an amount in excess of actual taxes resulted in a ratepayer contribution to capital, and that based on the imprudence of Pacific in not electing accelerated depreciation prior to the TRA and its continued obstinacy in refusing to opt for that alternative after being cited for imprudence, the Commission could legally continue to apply its traditional accounting practices in regard to the tax expense issue. The Court recognized that normalization results in "fictitious allowances for tax expense." (6 C 3d at 130.) The Supreme Court suggested the Commission could adopt a compromise between full flow through and normalization. Even though the decision annulled a Commission decision ordering normalization, Pacific did not appeal the decision further.

The 1972 decision annulled a Commission decision which was rendered prior to the 1971 Court decision. To prevent these rates from becoming final on the issue of tax expense the Court annulled the decision. This decision also was not appealed. The 1975 California decision held that:

"Ratemakers have discovered that if the total enterprise is either expanding or stable, the use of accelerated depreciation does not merely defer taxes, but eliminates them entirely . . . The result is a net tax savings to any utility using accelerated depreciation." (Emphasis in original) 15 C 3d at page 686.

Based on this the Court concluded:

"If the Public Utilities Commission in setting rates were to assume that tax deduction for depreciation under both the straight line and accelerated method would yield the same result in the long run, it would, in fact, award the utility a rate windfall. For it would have set rates as if the utility would incur tax expenses which it would never have to pay." Id. at 689.

The Court again reversed the Commission, ordering it to consider all lawful alternatives, noting that it could forthwith adopt an annual adjustment formula offered by the Commission staff. The annual adjustment formula of the staff, termed "pro forma normalization," is very similar in concept to the formula adopted by the California Commission in the present proceeding. Despite the fact that the 1975 decision again reversed a Commission decision that would have ordered full normalization and even recommended the adoption of a formula very similar to the one here on review, neither Pacific or General sought further review of the Court decision.

THE COMMISSION DECISION

The Commission rendered Decision No. 87838 on

September 13, 1977. It sought to render a decision which would comport with regulatory principles and at the same time be in accord with the federal tax regulations. As a result of said Decision the Commission ordered Pacific to refund to ratepayers $160 million of $430 million of past collected phantom taxes and ordered a reduction of $55 million of $240 million in present rates charged to ratepayers. General was ordered to refund $55 million of $122 million of past collected phantom taxes and ordered a reduction of $11 million of $55 million in present rates charged to their ratepayers. The end result of the Commission decision is that Pacific was allowed to retain $270 million in tax expense that will never be paid to Internal Revenue in actual taxes. For General the comparable figure is a $67 million retention of phantom taxes. In setting present rates, the Commission allowed Pacific to charge to ratepayers $185 million in phantom tax expense that will be collected from ratepayers but never paid to IRS in actual taxes. The comparable figure for General is $44 million. The end result of this scenario is that the two utilities get a windfall of a total of $337 million in back collected phantom tax expense and an ongoing annual rate increase of $229 million in phantom tax expense that will be

collected from ratepayers but never paid to IRS.

In its decision, the Commission adopted a formula called average annual adjustment. This formula holds all cost-of-service items constant for the test year except for the calculation of the sums in the tax reserve account. Because the amounts accruing in the tax reserve vary abnormally with respect to other utility expenses, the Commission chose to average the test year tax reserve expenses plus the succeeding three years. This methodoloty is consistent with regulatory principles and has been approved by the California Supreme Court. City of Los Angeles v. PUC (1972) 7 C 3d 331, 347; Pacific Tel. & Tel. v. PUC (1965) 62 C 2d 634, 645.

In regard to the investment tax credit, the Commission adopted a formula which adjusted the test year ITC every year based on the best estimate of the forthcoming ITC for the calendar year, again based on the fact that ITC varies abnormally in comparison with other utility expenses.

Despite the windfall profits awarded General and Pacific by the Commission, the utilities persist in thinking that somehow and in some manner they have been treated unfairly. There is no merit to their position. The California Supreme Court in its 1971 decision made it clear that the Commission had the authority irrespective

of the federal tax regulations to imput accelerated depreciation with flow through to the telephone telephone utilities. (6 C 3d 119, 130.) As already noted the 1971 decision annulled a rate order which would have ordered full normalization of the federal tax benefits. This decision was not appealed. Thus, to the extent that Pacific and General are allowed to retain any of the phantom taxes they have no cause to complain. Of course, in the present case they have been allowed to retain an overwhelming majority of the phantom taxes, approximately two-thirds of the reserve funds.

PROCEEDINGS AFTER THE COMMISSION DECISION

Having failed to win approval of their one-sided interpretation of the federal tax laws either before the California Commission or the California Supreme Court, Pacific and General now for the first time turned their sights on Internal Revenue as a potential ally in their attempts to impose their one-sided views on the California Supreme Court, the regulatory commission and the ratepayers. In doing so, Pacific specifically sought to have itself declared ineligible for the federal tax benefits and make itself liable for more than $1 billion in back benefits. Pacific's

letter to Internal Revenue specifically states that:

> "It believes that the Decision clearly conflicts with the eligibility requirements for these tax benefits, and it cannot in good faith seek rulings that the Decision is consistent with those requirements." (Pacific letter to IRS, page 6, dated September 29, 1977.)

General sent a similar letter to IRS, also seeking to have itself declared ineligible for federal tax benefits. Pacific and General then requested the Commission to join with them in the proceedings before IRS. The Commission refused, noting that the Commission seeks to preserve eligibility while the utilities seek ineligibility. Furthermore, there is an obvious confluence of interest between the utilites seeking ineligibility and IRS obtaining over $1 billion in back taxes as a result of ineligibility. All that is needed to accomplish the common objective is to locate employees of IRS who would be willing to render a ruling. This was accomplished and Pacific and General were successful in getting IRS to agree that indeed Pacific and General would be ineligible for federal tax benefits if the Commission decision was implemented. The IRS advisory rulings in regard to accelerated depreciation were submitted to the California Supreme Court by the two utilities. With these rulings before it, the California Supreme Court affirmed

the decision of the California Commission without opinion.

REASONS FOR DENYING WRITS

I. The Final Decision of The California Public Utilities Commission is Not Reviewable by This Court Since It Was Based On An Adequate State Ground.

This Court lacks the power to overrule decisions of state tribunals which are governed by interpretations of State Law (<u>Herb v. Pitearin</u> (1945) 34 U.S. 117). Even if a Federal question is raised by a given controversy, this Court has no jurisdiction to review the matter if that Federal question can be avoided. The Federal question can be avoided when there are adequate independent state grounds to support the decision of the state tribunal (<u>McCoy v. Shaw</u> (1928) 277 U.S. 302; <u>Johnson v. New Jersey</u> (1966) 384 U.S. 719, 735).

A. The Reasonableness of Specific Accounting Procedures is Properly One of State Law.

The instant decision of the California Public Utilities Commission was summarily affirmed by the California Supreme Court. The basis for such decisions rests substantially on interpretations of California Law. It was not necessary to consider any Federal issues in those opinions. Thus, petitioners are not entitled to a review by this Court of the California decisions.

The Commission was required to consider the proper interpretation of California Public Utilities Code Sections 451 and 454 which provide for reasonable ratemaking procedures. Likewise, the California Constitution, Article XII, guarantees to the people in California just and reasonable utility rates as determined by the Commission. The Commission was required to determine the proper treatment for certain unpaid tax revenues in light of these local statutes.

It is presumed that respondent Commission dealt fairly with petitioners in fixing rates. The Federal courts will not interfere with such decisions if the utility was given a fair opportunity to present its claims (Los Angeles Gas & Electric v. CRC, 58 F 2d 256 (D.C. Cir 1932), Aff'd 289, U.S. 287; Ashbury Truck Company v. CRC, 52 F 2d 263 (D.C. Cir 1931), Aff'd 287 U.S. 570).

In the instant case, it is apparent that the petitioners have had the benefit of extensive consideration for their claims on numerous opportunities before the Commission and California Supreme Court. Under Sections 451 and 454, supra, "the Commission has the power to . . . disallow expenditures that the Commission finds unreasonable." Pacific Tel. & Tel. v. PUC (1965) 62 C 2d 634, 647. "The same rule applies where . . . accounting

practices result in unreasonably inflated tax expense." San Francisco v. PUC (1971) 6 C 3d 119, 126.

In the instant case, petitioners argued before the Commission that they were entitled to retain funds collected from the ratepayers for taxes not actually paid to the Federal Government. The Commission determined that petitioners contentions were unreasonable by its finding of imprudence. This issue was considered before the Commission during hearings and rehearings as well as before the California Supreme Court on three separate occasions (San Francisco v. PUC (1971), supra; City of Los Angeles v. PUC (1972), supra; City of Los Angeles v. PUC (1975), supra).

B. California Law Prevents a Utility From Earning a Profit on Expenses Charged to Ratepayers.

California has determined that the tax benefits involved here result in permanent tax savings. It has also determined that a utility's expenses are payable by ratepayers only on a dollar-for-dollar basis. Southern California Edison v. PUC (1978) 20 C 3d 813, cert den - U.S. -. It therefore follows that any accounting procedure which inflates tax expense to ratepayers above that actually paid to IRS, is violative

of this State regulatory principle. Petitioners have accumulated over $1 billion from ratepayers in tax expense that will not be paid to the Federal Government. Yet they have been ordered by the Commission to refund only about $2 million. Petitioners have already unjustly profited from their imprudent conduct. To award them even more would make a mockery of state law.

C. Pacific is Precluded From Arguing That The Instant Decision Violates the Supremacy Clause the United States Constitution By Their Failure to Raise This Issue Before the California Supreme Court.

Public Utilities Code Section 1757 delimits the scope of judicial review for Commission decisions. Under this section, an applicant is precluded from seeking judicial review for issues and arguments not previously considered by the Commission on Petition for Rehearing. This limited scope of judicial review has received the approval of this Court in relation to matters not previously raised in the lower state court. New York ex rel Bryant v. Zimmerman (1928) 278 U.S. 63; Street v. New York (1969) 394 U.S. 576, 581-585.

In the instant case, Pacific argues before this Court that the Commission's decision violates Article VI of the United States Constitution. This argument was

not presented to the California Supreme Court. The failure of Pacific to raise the issue precludes review by this Court. Edelman v. California (1953) 344 U.S. 357; Barbour v. Georgia (1919) 249 U.S. 454; Mutual Life Ins. Co. v. McCrow (1903) 188 U.S. 291.

D. The Supremacy Clause Does Not Apply to The Present Proceeding

In the 1969 Tax Reform Act, Congress in Section 167(l)(2)(B) of Internal Revenue Code allowed public utilities who previously used straight line depreciation (Petitioners) to switch to accelerated depreciation only if they used a normalization method of accounting, pursuant to IRC section 167(l)(3)(G). The relevant Internal Revenue Code sections have reference to the taxpayer (Petitioners) and not the regulatory agency, the Commission. Secondly, the tax statutes have reference to a method of accounting. There is no reference to the abrogation of ratemaking principles in dealing with the reserve created by accounting methods. Thirdly, the tax statutes do not deal with the treatment of the reserve created by normalization accounting. General, Pacific and the Commission place primary emphasis on Treasury Regulation 1.167(l) - (l)(h)(6) to support their respective positions in regard to the proper

treatment of the deferred tax reserve. Again, as pertinent here, the regulation has reference to the taxpayer and not the regulatory agency.

During the course of Congressional debate, the House of Representatives considered language which would prohibit a State regulatory Commission from computing accelerated depreciation with flow through.[17] The House commented that these initial proposals would have the following effect: "If the taxpayer seeks to use accelerated depreciation, the regulatory agency will be permitted in effect to force the taxpayer to straight line depreciation by not permitting normalization. The regulatory agency will not, in such cases, be permitted to require flow through of deferred taxes." (H.R. Report #91 - 413, 91st Congress, 1st Session 1784.)

Congressman Wilbur Mills objected to these provisions because he believed Congress had no power to tell the California Public Utilities Commission how to fix its intrastate telephone rates. (Hearings on H.R. 6659, House Ways and Means Committee 3887, 91st Congress (1969).) The views of chairman Wilbur Mills prevailed. Consequently, the ultimate legislation did not restrict

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[17] H.R. 6659 as originally introduced on February 7, 1969. See also H.R. 8987.

the power of State regulatory commissions such as the California Public Utility Commission. (Section 441 Tax Reform Act 1969, Internal Revenue Section 167(1)(3)(G) and 167(1)(2)(B).)

From this brief summary of the Legislative history, it is apparent that Congress made a deliberate choice to permit State regulatory commissions wide latitude in setting rates, without eliminating the tax advantages contemplated by Internal Revenue Code Section 167(1)(3)(G) The effect of possible conflict between Treasury regulations and juisdiction of the Federal Power Commission was recently considered in California v. FPC (1974) 506 F 2d 228. In that case the Court ruled that "certainly nothing in either the Tax Reform Act of 1969 or general principles of administrative law require the FPC to defer to the judgment of the Treasury on the proper method of accounting." Id. at 232. See also FPC v. Memphis Light & Water Div. (1973) 411 U.S. 458, 466.

II. Petitioners Improperly Seek an Advisory Opinion From This Court.

To support its thesis that the instant decision will cause adverse tax consequences, General and Pacific solely rely on self-serving opinions obtained

by petitioners from the Internal Revenue Service. The opinions referred to in Appendices D and E were framed in terms of the facts presented by petitioners. The relevant regulatory rules and state laws were not considered by the Internal Revenue Service since Petitioners failed to deliniate them when seeking the proffered opinions. The taxpayers, petitioners herein, were in the unusual position of requesting that the Internal Revenue Service issue a decision which obstensively would increase their taxes. The opinions obtained were merely of the individual persons within the Internal Revenue Service who issued them. Bartells v. Burmingham (1947), 322 U.S. 126; Stub, Overbeck & Associates v. U.S. (1971), 445 F 2d 1142; Lincoln Savings & Loan v. Commissioner (1970), 422 F 2d 90; see generally 1 Mertens Federal Taxation Section 3.20.

Whether the interpretive rulings of the IRS will become the litigating position of the Department of Justice is purely speculative, especially in light of the many relevant facets of state, federal and regulatory law that were ignored by IRS in rendering its opinions. Therefore, at the present time there exists no conflict between the Commission decision and any other competent tribunal. Even if the advisory opinion of IRS

does become the litigating position of the Department of Justice, there will be no judicial or administrative ruling until a decision is rendered by the United States Tax Court (26 U.S. Code 7442), the United States District Court (28 U.S. Code 1346), or the United States Court of Claims (28 U.S. Code 1491), depending upon which avenue of litigation is pursued. Decisions of the Tax Court and District Court are reviewable in the United States Court of Appeals (26 U.S. Code 7482, 28 U.S. Code 1291) and thereafter to the United States Supreme Court by certiorari. Court of Claims decisions are directly reviewable to the United States Supreme Court by certiorari. Furthermore, federal courts are prohibited from issuing declaratory judgments on tax matters. 28 U.S. Code 2201. Therefore, the process of even considering the tax issue has not even begun.

What Pacific and General seek to do by means of the submitted letters from IRS is to create the erroneous impression that there is but one way to normalize taxes. This is patently not true. The statutes require that two items, tax reserve and tax expense, be calculated over the same period of time. It left state regulatory discretion to resolve how those items should be calculated in light of state regulatory principles.

This is precisely what the Commission has done.

All of the above serves as a means to illustrate that the issue before this Court is not the interpretation of a federal tax statute, but the regularity of the California Commission in applying state regulatory principles. The tax issue may eventually find its way to this Court, but only if the Justice Department decides even to litigate after thoroughly analyzing all parameters to the tax issue.

Internal Revenue Code contains numerous provisions for the resolution of tax controversies on an administrative level (26 CFR Sections 601.106-107 and IRC 7121) and judicial level (See IRC 6211 to 6216). It is well established that this Court will not consider the challenges of the taxpayer until there is an actual case or controversy. Section 6212 provides that the Commissioner will issue the taxpayer a 90-day letter advising him that there is in fact a controversy, which has not been resolved at the administrative level. By the terms of this letter, the taxpayer then is given 90 days to petition for a determination or resolution of the controversy before the United States Tax Court. In the alternative, the taxpayer may secure a judicial resolution of an actual claim by paying the

the disputed tax and seeking the refund in the District Court (28 U.S. Code 1346). Under either of these approaches, the Court knows that it is considering an actual controversy.

In the instant case, petitioners have chosen neither route. The disputed taxes have not been paid to the government, and no suit for a refund has been filed. Likewise, the Petitioners could have sought the 90-day letter, or judicial review in the United States Tax Court. Instead, they seek an advisory opinion from this court that the personal opinions of certain specified officials in the Internal Revenue Service are correct. Such advisory opinions are beyond the jurisdiction of this Court (Article III, U.S. Constitution).

III. The Decision is in Conformity With The Tax Statutes and Regulations And With State Law.

A. Accelerated Depreciation.

Petitioners lay primary emphasis on Treasury Regulation 1.167(l) - (1)(h)(6) for their contention that the Commission Decision violates IRC 167(l)(3)(G) and 167(l)(2)(B). Treasury Regulation 167(l) - (1)(h)(6) purports to govern whether or not normalized accounting is used in calculating the tax benefits associated

with accelerated depreciation. The regulation states that the amount of the deferred tax reserve deducted from rate base must not "exceed the amount of such reserve for deferred taxes for the period used in determining the taxpayer's tax expense." Under the Commission's formula both tax expense and the deferred tax reserve are computed over the same four year period as mandated by 1.167(l) - (l)(h)(6)(i). This is accomplished by taking an average of the four years and deducting the average amount from the test year rate base. A four year averaging method is used because of the abnormal growth of the deferred tax reserve. For instance, between 1973 and 1976 the deferred tax reserve disproportionately grew from \$136 million to \$430 million, more than a 300% increase. California law clearly requires accounting for this abnormal increase in the future tax reserve, when that "particular expenditure is extraordinary." City of Los Angeles v. PUC (1972) 7 C 3d 331, 347.

Based on a finding (Finding 5) that the growth in the deferred tax reserve is abnormal, the Commission was legally required to make adjustments in order to reflect the extraordinary growth in the tax reserve. This it has done.

Because the IRS regulations require that tax expense be computed over the same period of time, the Commission averaged the tax expense over the same four year period for which it averaged the deferred tax reserve.

In averaging the tax expense over the four year period, the Commission noted that because the abnormally growing deferred tax reserve is deducted from rate base, there will be less revenue to be taxed. The smaller amount of revenue will then produce less tax expense because total taxable income will be decreased. Because all cost of service items are held constant in this calculation, pursuant to City of Los Angeles, supra, there is decreasing tax expense over the four year period. Just as with the average tax reserve, the test year is adjusted by the average tax expense.

The IRS regulation set up an amorphous formula with which to calculate tax expense and deferred tax reserve over the same period of time. State ratemaking principles dictate that figures averaged over a period of years should be used to calculate these items. This the Commission has done. Because no more precise formula was called for by the Treasury regulations, the Commission's formula should not be rejected. "When the Congress, as here, fails to provide a formula

for the commission to follow, courts are not warranted in rejecting the one which the commission employs unless it plainly contravenes the statutory scheme of regulation." Colorado Interstate Gas Co. v. FPC (1924) 324 U.S. 581, 589; FPC v. United Gas Pipe Line Co. (1967) 386 U.S. 237, 87 S Ct 1003, 68 PUR 3d 321, 328.

The Commission assumptions underlying the treatment of tax expense are supported by exhibits submitted by Pacific and General and, further, by the fact that the effective tax rate has been declining (Decision 25A).

Pacific and General seek to buttress their interpretation of the tax statutes and regulations by reference to Example 1 of 1.167(1) - (1)(h)(6). Such reliance is misplaced. Example 1 assumes a historical "recorded test period," whereas the California Commission uses a future estimated test period. Furthermore, the example assumes that the period used for computing tax expense is the same as the recorded test period. This is not applicable to the formula adopted by the Commission, which makes adjustments to test year expenses because of the extraordinary growth of the deferred tax reserve, in accord with State law. City of Los Angeles, supra. In fact, none of the examples referred to applies to the precise procedure used by the Commission. At any rate,

it is apparent that example 1 operates on a different set of assumptions than that used by the Commission and is not applicable to the present case.

The purpose of the ratemaking process is to predict as reasonably as possible future revenues and expenses. Pacific Tel. & Tel. v. PUC (1965) 62 C 2d 634, 645. Based on this process, the Commission computed the affect of the abnormal growth of the deferred tax reserve, using normal ratemaking procedures previously approved by the California Supreme Court. In doing so, there is no error.

B. Investment Tax Credit.

The Commission adopted a procedure called annual adjustment in calculating the investment tax credit. The process involves reducing base rates each year based on estimates of that year's ITC. Cost of service is reduced by a rateable portion of the estimated amount of that year's ITC. In making the adjustment, all other rate base figures are held constant. Because ITC increases abnormally in relation to other expenses, this is a proper ratemaking procedure in accord with City of Los Angeles, supra.

C. Prior Commission Decisions Using Methodologies Different From Those Advocated by Petitioners Have Not Resulted in Tax Benefit Ineligibility.

Petitioners argue that any ratemaking methods other than their own, including flow through, are in conflict with the federal tax statutes and will result in ineligibility. Pacific was on accelerated depreciation with flow through until July 23, 1974, Pacific Tel. & Tel. (1974) 77 Cal PUC 117, as was General until November 26, 1974. General Tel. (1974) 77 Cal PUC 590.

Thus, for a period in excess of four years both petitioners had their rates set on the basis of accelerated depreciation with flow through. During this entire period the provisions of 167(1)(3)(G) and 167(1)(2)(B) in regard to accelerated depreciation and 46(f) in regard to ITC were in full force and effect. If the arguments of the utilities are valid then Petitioners have already lost their eligibility. Yet they obviously have not. In fact Pacific has just recently been cleared by Internal Revenue for any back tax liability prior to the year 1974. (Application 58223, Item 17.) General has not reported any lost tax benefits for the similar period of time.

Also, in Southern California Gas Company (1975) - Cal PUC -, Decision No. 85354, the Commission set the utility's rates based on flow through, as were

those of Southern California Edison Company (1975) - Cal PUC -, Decision No. 85294. Although it was argued that ineligibility would result, there have been no reports of lost eligibility.

Furthermore, in the case of Washington Utility Commission v. Pacific Northwest Bell Telephone Co. (1971) 93 PUR 3d 275, a higher rate base deduction was taken than existed in the deferred tax reserve for the test year, a methodology that is nearly identical with the present procedure employed by the California Commission. Although it was argued that loss of eligibility for tax benefits would result, again there was no loss of eligibility. It should be noted that the Washington case involved a Bell system telephone company. Thus, the Bell system (AT&T) is cognizant of ratemaking methodologies that are different than their own and that have not in fact resulted in lost eligibility for tax benefits. The present case is very similar to the Washington case, and will not result in ineligibility. But for the recalcitrant efforts of Pacific and General to have themselves declared ineligible, the eligibility issue would be a dead issue today.

It is also worthy of note that the present Commission Decision is consistent with the methodology

employed in prior Commission decisions. For instance, a five year average was used for the investment tax credit rather than the test year figure in Southern California Gas Co. (1972), 74 Cal PUC 30, 49. In calculating state taxes, the Commission used a three year average flow through for accelerated depreciation in Pacific Tel. & Tel. (1974) 77 Cal PUC 117. The methodologies employed in these decisions were based on the extraordinary growth of the relevant tax expenses, the same reasoning applied in the present case.

It can thus be seen that the Commission Decision is consistent with past practices, both inside and outside California, is based on sound and consistently applied State regulatory policies, and has not and will not result in lost eligibility.

IV. To The Extent, If Any, That State Regulatory Action is Inhibited, The Treasury Regulations are an Unwarranted Interpretation of Congressional Tax Statutes.

Primary reference for Petitioners' contentions regarding the deferred tax reserve is placed on Treasury regulation 1.167(l) - (l)(h)(6). If this regulation is construed to require treatment of the reserve which is not required by the Congressional tax statutes 167(l)(3)(G) and 167(l)(2)(B), it is at variance with the statutes and must be rejected.

In this regard, it is important to place in perspective the regulatory power of the Commissioner of Internal Revenue. It has been stated that "treasury regulations and interpretations long continued without substantial change . . . are deemed to have received congressional approval and have the effect of law." Helvering v. Winmall (1938) 305 U.S. 79, 83 L.Ed 52. However, the present treasury regulations dealing with the deferred tax reserve do not merit this treatment, since they are first impression rules applied to the Tax Reform Act of 1969.

Additionally, the Treasury Department may not restrict or enlarge the scope of a statute or supply a purported omission or create an exemption. World Service Life Insurance Co. v. U.S. (1973) 417 F 2d 247; Smith v. CIR (1964) 332 F 2d 671; U.S. v. Marett (1963) 325 F 2d 28; Mertens, Law of Fed. Inc. Taxation Vol. 1 Sec. 3.21.

> "The United States Commissioner of Internal Revenue may not prescribe any regulations which are not consistent with the federal tax statutes or which add a restriction to a statute which is not justified by the statutory language or the intent of Congress." (Emphasis added.) Government of Guam v. Koster (1966) 362 F 2d 248.

It is clear from a reading of the tax statutes, as distinguished from IRS regulations, that the treatment

to be accorded the tax reserve by a state regulatory agency is not proscribed.

Originally, Congress had proposed statutory language which would have expressly prohibited a regulatory commission from imputing accelerated depreciation with flow through. H.R. Dep. No. 91-413, 91st Congress, 1st Session 1784. This language does not appear in the final version as passed in section 441 of the Tax Reform Act, at section 167(l)(3)(G).

It is apparent that after full consideration of the matter, Congress affirmatively deleted any reference to action by state regulatory bodies in regard to the treatment of adjustments to a reserve. It therefore follows that the California Commission, especially in light of Congressman Mill's acknowledgment of Congress's lack of authority to limit state regulatory powers, was free to pursue traditional ratemaking principles in its treatment of the phantom tax reserve.

Petitioners argue that no greater sum can be deducted from rate base than exists in the deferred tax reserve for the test year used in setting rates. This interpretation would succeed in limiting regulatory authority in treatment of the deferred tax reserve, where Congress had already deleted a proposal which would

have straight-jacketed state regulatory agencies in their regulatory function. It is improper to reintroduce by administrative interpretation a construction that was expressly sticken by the legislature. Border Pipe Line Co. v. FPC (1948) 171 F 2d 149, 152.

The above cited case lends weight to the proposition that Congress by affirmatively expunging language which would have restrained state regulatory bodies from traditional methods of handling the tax reserve, intended the converse: to wit, the state regulatory agencies were free and unfettered in applying traditional ratemaking principles to the tax reserve. Colorado Interstate Gas Co. v. FPC (1924) supra; FPC v. United Gas Pipe Line (1967) supra; California v. FPC (1974), supra.

V. If the Federal Statutes and Regulations Intrude on State Regulatory Practices They are Invalid, Void and of No Legal Effect

The Tenth Amendment to the United State Constitution provides that "The powers not delegated to the United States by the Constitution, nor prohibited to it by the States, are reserved to the States, or to the people."

The prohibition on federal interference with state sovereignty applies to tax legislation and

regulations. "This Court has never doubted that there are limits upon the power of Congress to override state sovereignty, even when exercising its otherwise plenary powers to tax or to regulate commerce . . ." National League of Cities v. Usery (1976) 426 U.S. 833, 842.

Pacific and General's interpretation of the Congressional statutes and Treasury regulations would unlawfully restrain State regulatory agencies in their lawful function of overlooking the monopoly practices of utilities. This is not a proper function of Congressional tax legislation. This Court in regard to federal legislation binding state governmental function has stated:

> "Congress may not exercise that power so as to force directly upon the States its choices as to how essential decisions regarding the conduct of integral governmental functions are to be made." Usery, at page 855.

That the regulation of monopoly utility practices is an essential function of the state is clear. Article XII, Section 23, of the California Constitution establishes the Public Utilites Commission with the duty to regulate and fix rates. California Public Utility Code Section 451 requires those rates to be just and reasonable. California law holds that the State has

complete control over the rates charged by public utilities operating within its borders. Law v. Railroad Comm. 184 C 737. The case of People v. Western Airlines, 42 C 2d 621, found the powers of the Commission over the regulation of rates to be broad and comprehensive.

It is clear that the proposition Pacific and General argue for would involve interpreting Congressional legislation and tax regulations as if they were directed at the State regulatory agencies. This is what is prohibited by the Usery case, as it would deprive the State of applying traditional regulatory principles in regard to the regulatory treatment to be accorded federal taxes. TURN suggests that in light of the Usery case the utility argument for conditioning tax benefits on state regulatory methodology must be rejected. If the tax statutes and regulations do indeed impose such conditions on state regulatory bodies, the statutes and regulations are invalid, void and of no legal consequence.

VI. The Commission, To The Limited Extent That It Has Reduced Rates and Ordered Refunds, Has Acted Properly.

Petitioners next argue that the effect of ordering

refunds and reducing rates results in confiscation of their property because they have not earned their rate of return. This argument basically reduces itself to the proposition that refunds and rate reductions are not appropriate unless the utilities have earned their authorized rate of return.

Similar propositions were dealt with in City of Los Angeles v. PUC (1972) 7 C 3d 331, 355-359, and were rejected by the Court. The point to be emphasized is that the present authorized rates of return are based on an erroneous tax expense treatment by the Commission. Because prior Supreme Court and Commission decisions have provided for refunds based on the correct treatment of the tax expense issue, the utilities have no justifiable argument against refunds, even if they have not earned their rate of return.

Furthermore, a utility in California is not allowed to earn a profit on its expenses of operation. Southern California Edison v. PUC (1978) 20 C 3d 813, cert den - U.S. - (1978). It is uncontested that General and Pacific charge to ratepayers in tax expense an amount in excess of the taxes it actually pays to IRS. Thus, if anything, it is ratepayer money that is being confiscated, not utility earnings.

Pacific and General misconstrue the nature of the deferred tax reserve. These are not investor supplied funds but funds taken (confiscated?) from ratepayers to allegedly pay the utilities taxes. Not one penny of the deferred tax reserve is investor supplied. To allow the utilities to retain any of these funds is a generous gratuity.

Not only are ratepayer funds used as a source of capital, but they are obtained at the rate of two dollars of ratepayer funds for every one dollar of utility expense, a 200% rate of interest. Pacific Tel. & Tel. (1968) 69 Cal PUC 53, 61-62. Thus, to fund the tax reserves of General and Pacific, totalling more than $1 billion, the utilities require more than $2 billion of ratepayer monies, absolutely none of which is actually used in payment of taxes.

Lastly, the California Supreme Court has already held that the use of a formula tied to the growth in tax benefits, does not render the use of the formula confiscatory merely because it reduces the allowable rate of return. City of Los Angeles (1975) 15 C 3d 680, 703.

In determining whether confiscation has occurred, it is relevant to look at the financial picture of

General and Pacific. The Commission noted (36A) that Pacific has increased its shares outstanding from 104 million in 1961 to 168 million in 1975, to over 181 million in 1976. Earnings per share have increased over this period from $1.46 to $2.06. Earned surplus has risen $245 million from 1972 to 1975 and Pacific's construction budget increased $225 million from 1971 to 1974. All this was achieved in spite of the fact that Pacific refunded $176 million and had rates reduced $90 million per year (36A). It must be remembered that Pacific and General were on accelerated depreciation with flow through until 1974. In spite of this, and consequent refunds and rate reductions, the utilities made impressive economic advances.

Furthermore, on August 16, 1974, Pacific filed a memorandum with the California Supreme Court in S.F. No. 23215 and S.F. No. 23218, asking the Court not to stay Decision No. 83162, but to allow the rate of return to remain in effect subject to refund. Pacific concluded its argument at page 7 with the assurance that "Pacific is financially capable of any such refunds." The Court, as part of its decision in City of Los Angeles v. PUC (1975) 15 C 3d 680, 708, made the rates subject to refund.

It should also be noted that the tax reserve exists theoretically to meet some future tax laibility. If in fact that liability accrues, Pacific's witness testified that the utility would have to fund repayment since the tax reserve has been expended. (Volume 4, Transcript, page 369.) If the utilites can do this to tax payments, they surely can do the same for refunds.

VII. Conclusion.

The petitions to this Court should be rejected out of hand because they seek an advisory opinion on tax issues that present no case or controversy. Furthermore, the decisions before this Court are sustainable on independent State grounds enunciated by the Commission and the California Supreme Court over the last 20 years. On procedural grounds, Pacific's petition is inadequate for failing to raise its Supremacy Clause argument to the state court.

Substantively, petitioners request this Court to order the State of California to adopt a ratemaking mechanism which would require California citizens to subsidize their utilities by paying phantom taxes that in fact are never incurred. The decision Petitioners

attack allowed them to retain 75% of these phantom taxes. If anything, California ratepayers should be made whole by returning all tax savings to the actual taxpayers, the citizens of California.

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